Just Another Dot-Com?: Precept believes its loan origination system will lift it above the commercial real estate online loan matching heap.(Company Business and Marketing)

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Amidst the rubble of the dot-com collapse, Precept, yet another com mercial real estate loan matching dot-com (www.preceptmortgage.com), has set up shop, with hopes of revolutionizing the commercial mortgage loan origination and lending process. Although the "lack of human contact" negative that dogged the failed commercial real estate-related online loan matching services still holds good for Precept, the San Francisco-based company hopes to differentiate its loan origination system in some key aspects.

For one, unlike some other dot-coms that had sought to market themselves by disintermediating brokers, Precept provides incentives for borrowers to go through brokers. Also, Precept takes care of the collateral validation and valuation process on behalf of lenders and gives lenders upfront information based on which they can make their pricing decisions. In the final step of the Precept loan matching process, lenders bid online for loans.

Borrowers are given a firm commitment at this stage and need not shop their loans around to different lenders. These improvements could decrease the cost of investment in commercial real estate debt, Precept believes, and make the market more liquid and efficient.

A Better Mousetrap

Frank Scavone, chief executive officer of Precept, says that they targeted this marketplace after he and some coworkers noticed the inefficiencies in the commercial mortgage loan origination process while they were working at Capital America (including Joseph Heil, chief operating officer and co-founder of Precept, about 90% of Precept's employees are from Capital America). He recalls, "We saw a lot of problems, a lot of inefficiencies and redundancies that existed within the business community and the way that business was transacted. Loan requests were going out to the lending community before any analysis had been performed, or before anyone had any really good information on what it was that they were trying to finance. And because loans or loan requests from brokers or from borrowers would go directly before any true analysis out of the lending community, the lending community had to create an overcapacity of origination infrastructure. And we thought perhaps there is a way to make this better. And the business plan that we put together in March 1999 was one whereby we essentially reversed the sequence of the transaction."

Taking a lead from the way the lending process is conducted in the case of other asset classes, they realized that commercial real estate investors did not need to do all the processing and validating of their investment, and could leave that to credible and objective intermediaries instead. Mr. Scavone said, "So we thought, what if we created a process whereby someone who had that credibility could do all that work and make it so that the lenders really only competed by virtue of their own cost of capital and their intelligence in pricing the risk associated with

that particular investment? And if that was in fact the case, you wind up saving a great deal of time for the lenders. By comparison, the historical process could take 30 or 40 days and if you added up all the time, someone would probably spend 30 or 40 hours in getting to the point where they understood what they had so they could make a meaningful loan commitment. And the way that we have reversed the sequence, lenders come in at the end of the process and, in about an hour, they can be in exactly the same position."

A Second Opinion

On showing the system around to lenders, Precept was able to get the interest of some major names such as Morgan Stanley, Salomon Smith Barney, I-Star Financial, Cohen Financial, Pacific Life, Secured Capital, and Greenwich, who have invested in the company. Precept has also garnered an investment interest from Standard & Poor's, the New York-based debt rating agency. S & P co-underwrites loans that go through the Precept system, before the lenders see them, and provides a second opinion on the underwritten cash flow, in addition to the initial site inspection and underwriting analysis done by Precept. Mr. Scavone noted, "So now we have created a situation whereby lenders get on our system, they look at these loan opportunities and they have to spend very little time to make their decision. And the information that they use to make that decision they know is highly credible." Another advantage of S & P's underwriting is that if the loan is to be later securitized, and S & P is involved in the deal the lender is not likely to have to change the underwritten cash flow, subject to any material adverse change at the property level.

Borrowers too stand to benefit from seeking a second opinion - the broker's. The system is actually set up for the convenience of mortgage brokers, and Precept actively price discriminates against direct borrowers. This means that brokers registered with Precept are charged less to use the system. In fact, to use the Precept system through a registered broker, it costs only about one tenth of the price that a direct borrower would pay. Mr. Scavone said this is because there are lots of complex loan parameters which direct borrowers are not used to dealing with on a daily basis. Also, it is less expensive to market direct to loan brokers and Precept need not spend a lot of time training them. Besides, Precept is a facilitator of the loan auction process and wants to remain objective throughout the process. Mr. Scavone explained, "We can't tell a borrower to take that bid or that's the best deal. We can only sit there and facilitate the bidding process and the auction process. So really if someone is going to negotiate on behalf of or advise the borrower, that would be a conflict with our position to take on that role. So a borrower is pretty much better off going through a registered broker who knows what he is doing on the system and using that broker to help him navigate and negotiate and interpret what it is that's happening."

Multi-stage Auction Process

The auctioning of loans is carried out at Precept's website. Precept takes all the underwriting information and will put it up along with the borrower's financing request about what kind of loan they want and any additional information, such as photographs of the property. The website provides secured access so that only Precept lenders with passwords can look at the information it has posted online. The auction itself could stretch out into a number of phases. It starts off with a sealed bidding phase during which the lenders submit bids and can't see the

terms of each other's bids. The borrower and their broker can see the bid though. If this sealed bidding doesn't lead to an acceptable offer, it is followed by an open bidding period during which lenders can see each other's bids. Mr. Scavone noted, "Then you see a situation (during open bidding) where you can get auction frenzy and that's no different than sitting in a room at Christie's or Sotheby's and seeing guys kind of fight to win the loan. They bid on everything - it is not just the interest rate and the amount of money they lend. There are about 90 parameters that they are actually bidding on - price, proceeds, the terms of prepayment, the structural parameters. So it is extremely complex and that's why you need a sophisticated level of representation." If there is a lack of market interest in a particular loan - less than two bids - designated market makers will step in to save the day. Morgan Stanley and Salomon Smith Barney have both elected to be Precept's market makers, responsible for generating upto $2.5 billion a year in bidding activity. When a winning bidder emerges, Precept will also co-ordinate most of the closing functions on their behalf, including matters relating to title, insurance review, and creation of closing documents.

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High Tech, Not High Touch

Potential users of the Precept system remain skeptical about the low level of human interaction required by the system and say that the commercial mortgage loan origination process is still largely dependent on interpersonal relationships. Brian Stoffers, executive managing director, LJ Melody & Company, a Houston-based mortgage banking company, said that LJ Melody has some loan officers in the field who will be testing the Precept origination system soon and might use it to place loans. He observed, "This business requires a lot of human touch and it remains to be seen how much the electronic medium, through technology, will supersede what human interaction can do currently." Another drawback, he believes, is that Precept requires borrowers to put up upfront fees and deposits for underwriting. Some borrowers might be hesitant to do that, he said. However, since the current system is somewhat inefficient, Mr. Stoffers thinks that Precept "may be able to help smooth out the process." It is more likely to be helpful for "smaller mortgage banking firms," he believes, since "it remains to be seen if there is enough value added for the large mortgage banking firms (such as LJ Melody) that are doing a lot of volume with a good number of sources."

Steve Spayer of Cohen Financial, Chicago - a Precept registered broker that has one loan heading for auction on Precept - said Cohen primarily views Precept as a vehicle to achieve a lower cost of origination for Cohen's borrowers and as a tool for their sales people, rather than as a vehicle to sign borrowers. He noted, "We are not viewing it as an origination system in the broader sense. We are very supportive of the traditional sales-oriented method and the business is still very high touch in terms of having to interact with customers. We see the tool helping most in terms of hopefully being an alternative to some of our borrowers." Thus, it is most likely to be useful to borrowers who have a loan with clean underwriting and who would benefit from competitive pricing and from being able to close the loan faster through Precept, Mr. Spayer said. He remarked, "So far, it is best

suited, at least initially, for Wall Street and conduit lenders. So the challenge has been finding loans that fit that easily and in finding borrowers who are interested in trying something new."

While the Precept system itself is designed for all types of loans, Mr. Scavone said that the early adopters of the system have been securitization lenders. He noted, "Even the banks and life companies that have signed up to be lenders on the system are really doing it off their capital markets desk, through their securitization programs." Precept is interested in all property types except advanced healthcare. Mr. Scavone said, "We will ultimately do nursing care, but not right now. It is just a complex asset class and we have to have people to underwrite who specialize in that area. It is not where the majority of the product is and you have to take your resources and employ them where you get the biggest bang for the buck." As of early May, there are three loans that are heading for auction on the Precept system - two small transactions under $10 million and one larger transaction in the $30 million range. There are also over a dozen registered lenders and over two dozen mortgage brokerage firms that have signed up to use the system, according to Mr.Scavone.

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